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POSSIBLE FUTURE WORK

Note by the Secretariat

Addendum

Legal issues in privatization

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INTRODUCTION

1. At the Congress on International Trade Law, held by the Commission during its twenty-fifth session in May 1992 in New York, a suggestion was made to consider preparation of a legal guide on contracts for privatizing State-owned enterprises with a view to helping States in the process of privatization as well as protecting the legitimate interests of private investors.

2. The purpose of the present note is to facilitate considerations in the Commission as to whether work should be undertaken in the area of privatization.

I. GENERAL REMARKS

3. "Privatization" is a widely used term to refer to a process by which State-owned enterprises are transferred, through different types of contracts, to private parties. The term "privatization contract" is used in this note to refer to a contract by which a State-owned enterprise is transferred to a private party.

4. Motives for privatization are, for example, to make the national economy more market oriented, to reduce the influence of the State over enterprises, to foster the creation of a class of managers who will run enterprises as commercial businesses, to introduce or expand the private ownership of company shares among the population, to increase efficiency in the utilization of the resources of enterprises, to obtain revenues for the Government, and to reduce public debt.

5. The process of privatization has been undertaken in many States from different geographic regions and at different levels of industrial development. In recent years, privatization is being carried out on a large scale in States that are abandoning the system of socialist ownership and State-planned economy in favour of a market economy based on a broader private ownership of enterprises.

II. LEGISLATIVE FRAMEWORK FOR PRIVATIZATION

A. Need for adequate legal infrastructure

6. For a privatization programme to be successful, it is necessary for the State in question to have in place suitable laws and institutions that allow and protect individual and corporate ownership of commercial property, that inspire confidence in potential domestic and foreign investors and that provide a harmonized legal system for the carrying out of the commercial activities of privately owned enterprises. Many States with a privatization programme that have had a longer tradition of private ownership of enterprises have been developing such laws and institutions over a long period of time and, as a result, in those States no major legislative work is required. However, in States in transition from socialist forms of ownership to private ownership extensive legislative and administrative work is required to establish those laws and institutions.

7. The needed laws and institutions may concern diverse areas such as: ownership and transfer of immovable commercial property; prerogatives of the State in determining the use of land; environmental protection; types, formation, organization and limited liability of companies; restitution of nationalized property to former owners; various types of commercial contracts; intellectual property; securities and stock markets; banking and financial services; tax system; competition and restrictive business practices; insolvency; employment matters; accounting; dispute settlement procedures.

8. In some of the areas of law just mentioned harmonized international legal texts exist. In other areas, national laws are used as models.

B. Specific laws on privatization

9. In many States, the implementation of a privatization programme is based on a law adopted specifically for that purpose. The types of issues covered by such laws differ widely from State to State and depend on factors such as the existence of legislative rules necessary to support private ownership of enterprises, and the need to establish a governmental institution or institutions to administer the implementation of the privatization programme.

10. The following list, prepared on the basis of a limited number of national laws on privatization, indicates issues that have been addressed in such national laws:

- objectives of the privatization programme;
- enumeration of the enterprises to be privatized or the authorization of a body to determine the enterprises to be privatized;
- procedures for deciding to privatize a company;
- methods of privatization (e.g., sale, lease, entrusting the management of an enterprise to a private entrepreneur, "build, operate, transfer" (BOT) contract);
- the responsibilities of the State bodies in charge of administering or supervising the implementation of the privatization programme;
- persons and entities to which State-owned enterprises may be transferred, with special provisions, for example, for the employees of the enterprise, its managers, and foreign investors;
- preferential rights of employees of the enterprise to be privatized (e.g., to buy an amount of shares at discount prices or by installment payments);
- quotas of shares to be offered at preferential terms to certain categories of the population;
- a requirement that the buyer have experience in the trade of the enterprise to be privatized;
- procedures for administering the sale of shares to preferred purchasers, which may include, for example, rules on the distribution and sale of coupons incorporating the right to purchase shares;
- special provisions for privatization in certain industrial sectors;
- the process of selling an enterprise, e.g., bidding, auction, offering of shares in a securities market, direct sale of shares;
- dividing or transforming State agencies engaging in a commercial activity into commercial corporations to be privatized, with provisions on the allocation of assets and liabilities to those corporations;

- procedures for determining the price of the enterprises to be sold;
- payment terms, including the possibility of paying the price in installments;
- possibility of paying the price with claims against the State ("debt-for-equity swap"), and the manner in which those claims are offered for sale to prospective purchasers of enterprises;
- obligations by the State to use the proceeds from the sale of enterprises for specified purposes (e.g., to reduce public debt);
- the possibility that the State will retain responsibility for certain obligations of privatized enterprises that arose before the privatization (e.g., obligations arising from environmental damage or labour relations);
- registration of enterprises;
- provisions on the content of by-laws of enterprises to be privatized;
- accounting rules;
- liquidation of non-viable State-owned enterprises and the sale or other use of their assets;
- protection against nationalization granted to domestic and foreign investors, cases in which nationalization is nevertheless allowed (e.g., when public interest is established by a legislative body), and a timely and fair compensation for nationalized property;
- tax treatment of parties that take over State-owned enterprises;
- the possibility of transferring income, or proceeds from the subsequent resale of an enterprise, to a foreign country;
- employment and social rights of the employees;
- form and structure of a privatization contract (e.g., written form, signatures, parties to the contract, the names of any intermediaries, manner of describing the assets to be privatized);
- commitments that an investor may be required to make in the privatization contract (e.g., that the buyer will maintain a certain level and structure of employment; conclude a collective employment contract with employees; not sell the enterprise during a certain period; maintain a production programme; make investments of a certain kind or in an agreed amount; adhere to a determined pricing policy; take specified measures to protect the environment; avoid certain restrictive business practices);
- the right of the State to invalidate a privatization contract in case of certain violations of the law or in case of certain kinds of breach of the privatization contract;
- fines for infringements of the law.

III. PRIVATIZATION CONTRACTS

A. General remarks

11. Enterprises are frequently privatized by being sold to private investors. The following section B describes some clauses specific to contracts for the sale of an enterprise. Sections C and D describe briefly the leasing of State-owned enterprises and the entrusting to a private party of the management of a State-owned enterprise.

12. A frequent characteristic of negotiations for the conclusion of a privatization contract is that the State may be guided not only by commercial criteria, but also by social, employment or industrial objectives of the Government. The influence of those objectives may lead to a decision to transfer an enterprise to a party that, while not offering the best financial

terms, for example, guarantees to keep the existing employees or that has fewer oligopolistic ties than the other bidders. The weight to be given to those governmental objectives varies from case to case, and often no predetermined weighting formulae are given to the bidders. In order to prevent improper applications of such non-commercial considerations, some States have adopted rules such as that sales at or below the net-book value of an enterprise must be audited and specially approved.

13. As part of the negotiation process, bidders are usually requested to submit a business plan describing the intentions of the prospective owner. The plan is usually required to be structured in such a way that it indicates how the bidder intends to address the governmental objectives referred to in the preceding paragraph. For example, the bidders may be requested to indicate the expected level of investment (specified, e.g., as to fixed assets, working capital, technology and human resources); projected employment over the next several years; and plans for developing the enterprise, its production and markets.

14. In order to facilitate and expedite negotiations, prospective buyers are often granted access to certain business records or similar sources of information. Such access is typically conditioned by a commitment to keep the information confidential.

15. For the finalization of the terms of the privatization contract it is necessary that during the negotiations the prospective buyer is given information about the various encumbrances of the enterprise. Those may be, for example, land mortgages, patents, licences, significant contract duties, outstanding debts and assignments of claims and rights. In some cases, in particular when the governmental entity selling the enterprise had not exercised effective control over the enterprise, extensive work may be necessary to establish all the encumbrances by checking various records, reviewing contracts, and interviewing managers of the enterprise.

B. Sale of enterprise

(a) Employment clause

16. Privatization contracts may stipulate the number and structure of full-time jobs that the purchaser agrees to maintain for a specified period of time. Such a clause may be included in the contract in exchange for a price that is lower than the initial price based on the assessed value of the enterprise.

17. For the case that the new owner does not live up to the commitment, an increase in price, liquidated damages or a penalty may be stipulated. The formula for the amount to be paid may be set in such a way that the payment to the former owner for each employee laid off contrary to the agreement would come close to the cost of keeping the employee. Sellers usually refuse to accept generally formulated clauses releasing the buyer of its commitment in case of "conditions beyond the purchaser's control". In few cases sellers have accepted more specific clauses setting out the values of market indicators that would modify the new owner's commitment.

(b) Investment clause

18. The purchaser may commit itself to invest in the enterprise. Such commitments usually refer to monetary investments and specify the amount of

investment and the time during which the amount must remain invested. Such an investment clause often sanctions the breach of the commitment with a payment of up to 50 percent or more of the investment not made.

(c) Speculation clause

19. The contract may call for a re-valuation of the purchase price, usually by a neutral expert, and for payment of a higher price if the privatized enterprise is sold before the expiry of the specified period (e.g., between 5 to 15 years) without having met the social targets mentioned in the contract. An alternative to such a re-valuation clause may be a "surplus levy" clause according to which the purchaser is obliged to pay an amount based on the difference between the price paid for the enterprise and the resale price.

(d) Business continuation clause

20. Some contracts provide that if the purchaser discontinues production before the agreed point of time, liquidates the enterprise, lets it go bankrupt or modifies the production programme in a significant way, the purchaser will have to pay an agreed amount. Usually it is agreed that the amount to be paid decreases over a number of years until the clause ceases to be operative.

(e) Re-valuation clause for real estate

21. In some cases, in particular when it is difficult to measure the value of real estate or when extraordinary instability in the real estate market is expected, the contract may include a clause according to which the State is to benefit from an increase in the value of the real estate if it occurs within the agreed period. Such a clause may apply only to the land or also to some of the buildings. In order to safeguard the purchaser's interests, such clauses may maximize the increase that must be returned, provide that only a certain percentage of the increase is to be returned, specify that only an increase over the agreed threshold is to be taken into account, stipulate the method for establishing the value of the real estate (e.g., by neutral experts), or provide for a respite for any payment to be made on the basis of the clause.

(f) Payment clause

22. The payment clause would address issues such as the time when the purchase price is to be paid, payment guarantees for deferred payments, and the interest rate. Usually the seller insists that the purchaser itself be committed to pay the agreed amounts, instead of limiting the purchaser's responsibility by placing some of the payment obligation on the newly founded company.

23. In some States laws have been adopted according to which the parties to a privatization contract may agree, with specified limits, that the purchaser will pay a part of the price by assigning to the State payment claims against the State ("debt-for-equity swap"). Prospective buyers would typically buy those payment claims from foreign creditors for the purpose of making payments in the context of privatization.

(g) Clause on reserves for potential liabilities

24. At the time of the sale of an enterprise, it may be uncertain whether the past activities of the enterprise will give rise to liability. For the case that such liability materializes, the privatization contract may establish a financial reserve to cover any liability.

25. Under one approach, used in particular if the likelihood of liability appears somewhat remote, the originally calculated price for the enterprise is not reduced, and the State undertakes to cover the liability up to a specified amount. Under another approach, which may be used if liability is likely to materialize, the price calculated originally is reduced by an agreed amount; if the liability does not materialize within a specified period, the owner of the enterprise is to pay to the State the amount by which the originally calculated price was reduced. In order to avoid improper use of the reserved amount, the State may be given a right to participate in any negotiations or dispute settlement proceedings concerning the liability; in addition, in order to provide to the owner an incentive for limiting payments from the reserve, the owner may be given a right to keep a percentage of the reserve if it is not used.

(h) Repair of environmental damage

26. One of the risks the new owner of an enterprise is to bear in mind are expenditures needed to bring the site of the enterprise up to the legally required environmental standards. Since the cause for those expenditures existed before the privatization, the seller of the enterprise may be ready to bear a specified proportion of any such costs. For example, it may be agreed that the buyer will assume responsibility for specified clean-up work up to a specified amount, while further costs up to an agreed amount are to be shared in a specified way, and any excess costs are to be borne by one or the other party. Different formulae may be used for different kinds of environmental problems (e.g., spent oil, smoke emission, asbestos). The contract may provide for the right of the State to approve the plans and contracts for the expenditures in which the State is to participate. Any environmental consequences that arise after the enterprise has been privatized would normally be the sole responsibility of the enterprise.

(i) Seller's warranties

27. The assumption is that the seller is the owner of the enterprise and that the enterprise owns its real estate, and the privatization contract may express that assumption. If it is possible that third parties might dispute the ownership, it is advisable to address that possibility in the contract. Issues concerning ownership might arise, for example, because of unclear or inaccurate records of the enterprise being privatized. Those issues may arise also in the context of legislation on denationalization, which are mentioned in the following paragraphs on "restitution claims".

(j) Restitution claims

28. A number of States in transition from a socialist system of ownership to a private system of ownership have adopted laws according to which former owners of nationalized property have a right under specified conditions to reclaim ownership in the nationalized property.

29. Sometimes it is possible, in parallel with the contract for the privatization of an enterprise, that the State reaches a settlement with the former owners of the enterprise or their successors by paying compensation to them from the proceeds of the privatization. If such a settlement cannot be reached during the period the privatization contract is being negotiated, the State may, by a clause in the privatization contract, accept the obligation to settle the former owner's claim within an agreed period and agree to an interim arrangement until the restitution claim is settled. The interim arrangement may be, for example, that the prospective buyer assumes the management of the enterprise, the State retains a partial responsibility for certain costs and losses of the enterprise, and the duty of the prospective buyer to make the agreed investments is postponed until the privatization contract takes full effect. The privatization contract would take full effect when the claim of the former owner has been settled, unless the settlement has not been reached by the agreed time limit and the prospective buyer terminated the contract.

30. If the former owner is claiming not the enterprise itself but an item of property of the enterprise, the privatization contract can be finalized under the condition that the State assumes the obligation to settle the claim or to pay to the new owner of the enterprise the value of the property that had to be surrendered to the former owner. If the return of the particular property compromises the viability of the enterprise, it may be necessary to terminate the privatization contract and settle the outstanding claims.

C. Leasing of enterprise

31. The State may decide to lease an enterprise to a private party, for example, when it wishes to retain the ownership while considering that the efficiency of the enterprise is likely to improve under the management of a lessee; when the purpose is to obtain an annual income from the enterprise; when the Government decides to experiment with the private management of an enterprise as a prelude to the sale of the enterprise; or when no suitable buyer has emerged, while there is a prospect to find a lessee.

32. The follcwing are examples of advice given in respect of contracts for the leasing of enterprises:

(a) the leasing period should be sufficiently long in order to give the lessee an incentive to run the enterprise in a way that will be in the long-term interest of the enterprise;

(b) the contract should contain clauses obligating the lessee to maintain the value of the assets; such clauses are necessary in order to avoid that the lessee's short-term interest in profits would adversely affect the long-term value and viability of the enterprise;

(c) the amount of the leasing fee may be fixed for the entire leasing period, or it may be flexible so that the government would benefit from increases in the profits of the enterprise; the increases in the lease payments should be so designed as not to affect negatively the lessee's interest in operating the enterprise;

(d) it is necessary for the contract to indicate clearly, on the one hand, the scope of the lessee's autonomy in managing the enterprise and deploying the personnel, and, on the other hand, the prerogatives of the State in those areas;

(e) it is advisable for the contract to contain provisions against the lessee managing the assets, and manipulating the profit-earning picture, of the enterprise in such a way as to discourage potential bidders for the purchase of the enterprise.

D. Management contract

33. The State may wish to transfer to a private party only the management of the enterprise, pay the private party a fee therefor, and retain the other ownership functions. This method of privatization may be used, for example, when the enterprise has been making losses attributable to managerial inefficiency or where the new management should improve the economic and commercial position of the enterprise with a view to achieving later a better sales price for the enterprise.

34. The following are examples of advice given in respect of management contracts:

(a) a management contract should clearly demarcate the services that are covered by the management fee from the services that are necessary from time to time and are to be paid separately;

(b) the fee payable to the management may be composed of an agreed amount and an amount to be calculated on the basis of the profits of the enterprise or on the basis of the physical extent of production or sales;

(c) the contract should contain clear provisions as to the powers of the management in determining the production programme, prices and employment policy;

(d) if the management of the enterprise is entrusted to a company that is also involved in supplying goods or services to that enterprise or is selling its products, it is advisable to agree on clauses that would prevent improper pricing of goods or services and the enterprise becoming dependent on the business with that party for its viability and profit.

35. Some advice mentioned above concerning the leasing contract apply, mutatis mutandis, also to management contracts.

IV. WORK OF OTHER ORGANIZATIONS ON PRIVATIZATION

A. United Nations Development Programme

36. In 1991, "Guidelines on Privatisation" were prepared by the Interregional Network on Privatisation, which is a group of experts from developing countries personally involved in privatization and which works under the auspices of the Division for Global and Interregional Programmes of the United Nations Development Programme (UNDP).

37. The issues considered in the Guidelines include: whether a State authority should be set up to manage the process of privatization and its powers and responsibilities; possible need for legislation authorizing privatization of public enterprises; transformation of non-corporate public enterprises into stock companies; measures to promote competition; leasing and entrusting the management of an enterprise to a private party as methods of

privatization; full privatization of a company or the sale of only a part of the shares in a company; sale of an enterprise to its managers and employees; sale of an enterprise to a cooperative society of investors; sale of assets of an enterprise instead of the sale of the enterprise itself; valuation of assets and liabilities of an enterprise and related valuation of the enterprise as a whole; setting a price for assets; techniques of sale of shares; joint ventures; need to develop a capital market; impact of privatization on employees; regulatory interest of the Government in privatized enterprises and means of continued influence of the State in privatized enterprises; considerations regarding the sale of enterprises to foreign investors.

38. The Guidelines describe, in chapter 23 entitled "Technical assistance and co-operation", various possibilities for a Government to obtain technical assistance in formulating its national policies and laws relating to privatization or in privatizing an individual enterprise.

B. Asian-African Legal Consultative Committee

39. The Secretariat of the Asian-African Legal Consultative Committee (AALCC) prepared for the 32nd session of the AALCC in 1993 a preliminary study entitled "Legal issues involved in the matter of privatization of State-owned enterprises" (AALCC/XXXII/KAMPALA/93/13). According to the document, the final objective is the preparation of a guide on legal aspects of privatization in Asia and Africa, and the principal aim of such a guide would be to assist the AALCC member Governments in carrying out their privatization programmes in a manner consistent with their national economic interests.

40. The preliminary study considers experience with State-owned enterprises, discusses reasons for privatization, and briefly compares various methods of privatization (such as an outright sale of an enterprise, sale of a minority part of a company, entrusting the management of an enterprise to a private party, lease of an enterprise, and a concession to operate an enterprise). The study also mentions amendments to national laws that might be necessary to carry out a privatization programme.

C. Economic Commission for Europe

41. The Working Party on International Contract Practices of the Economic Commission for Europe approved in 1990 a guide entitled "Legal Aspects of Privatization in Industry" (ECE/TRADE/180, United Nations, New York 1992). As stated in the introduction, the aim of the guide is to assist countries in transition in their task of establishing a suitable legal framework for privatization, and it does so by outlining: the principal problems most likely to arise in the course of privatizing enterprises; the new laws and institutions which will be required; and the main methods than can be employed in the task of privatization.

42. As to the main problems in privatization in Eastern Europe, the publication considers: the need to establish administrative institutions responsible for executing the privatization programme; clarification of the question of ownership rights of the State; de-monopolization of enterprises created in a centrally-planned economy and possibly their break-up into smaller and competitive units; determination of the appropriate price for selling an enterprise; the need to create capital markets; the question

whether, before selling an enterprise, certain restructuring measures should be taken (e.g., replacing or upgrading of machinery, laying off of redundant workers or liquidating debts that impair the solvency of the enterprise); protection of new owners, particularly against nationalization without prompt and effective compensation.

43. Furthermore, the publication discusses various segments of the legal system that must be adapted to a market economy and that are necessary to inspire confidence in potential investors. The types of laws discussed are in particular those on establishing and protecting property rights; the transfer of ownership of land and commercial enterprises; foreign ownership of land; State control over the purpose for which land is used; liability for environmental damage caused by the enterprises to be privatized; restitution of nationalized property to former owners; status, establishment and functioning of business organizations (company law); contract law; insolvency proceedings; securities; taxation; promotion of competition; employment; and accounting practices.

44. As to the main methods of privatization, the publication refers to the sale of State-owned enterprises; sale or leasing of State-owned assets; and granting to the private sector of contracts for services that had previously been provided by the State itself.

45. The same Working Party has also prepared a document entitled "Guide on Selected Legal Issues Related to Privatization and Foreign Direct Investment in the Economies in Transition: A Comparative Analysis" (TRADE/WP.5/R.9/Rev.1, 25 November 1992), which is intended to be revised and, with some additions, issued under the new title "Privatization and Foreign Investment in the Countries of Central and Eastern Europe: Legal Aspects".

46. Furthermore, the Working Party has prepared a preliminary outline of a future publication to be entitled "Guide on the Financing of East-West Trade/Privatization in Central and Eastern Europe" (annex to document TRADE/WP.5/45, 1 December 1992). The outline indicates that the guide will deal, among other issues, with measures to improve the legal framework for financing in the economies in transition. Those measures will concern, for example, improving the legislative process, fixing priorities in the development of legislation (civil code, commercial code, procedural laws); problems of implementation and enforcement of new legislation; property laws; role of commercial banks in economies in transition; problems of restitution of nationalized property from the point of view of financing; types of corporate entities; registration formalities; issues of labor law; security interests; debt-for-equity swap; taxation issues; terms and conditions of leases; franchising; intellectual property problems; methods of foreign investment; present position as to capital markets; mergers and acquisitions; methods of privatization; methods of financing; the role of international and national lenders; build-operate-transfer (BOT) transactions; problems of exchange risks and mechanisms for reducing them; use of offshore escrow accounts; use of exchange controls; dispute resolution; government guarantees; sovereign and other immunity; training and transfer of financial know-how.

D. European Communities

47. The Commission of the European Communities has, in conjunction with the Commonwealth of Independent States, set up a Task Force on Law Reform with the aim to assist the Independent States in drafting the most important market-economy laws, in developing training programmes for legal personnel,

and in building or improving institutions for implementing market-economy legislation.

E. International Chamber of Commerce

48. The International Chamber of Commerce (ICC) has set up a Special Task Force on Privatization. According to the ICC Handbook 1992, the Task Force "aims to accumulate knowledge about countries' experiences with privatisation for general use by members, especially members in developing countries and central and eastern Europe."

CONCLUSION

49. As noted above in paragraphs 6 to 8, in some States, in particular those in transition from a system of socialist ownership of means of production to a system of private ownership, the implementation of privatization programmes requires extensive legislative work in a number of areas of national law. While in some of those areas legislative work can be based on international treaties and model laws, in other areas the only models available are foreign national laws. Yet, even where international legal texts exist, they are often not used, and instead foreign national laws are taken as models. It is suggested that, despite circumstances conducive to using national laws as models (e.g., historical ties or extensive trade with a country, or a tendency of experts providing technical assistance to offer their national laws as models), in many instances it would be in the best interest of the State concerned to adopt internationally harmonized texts. International texts tend to be more modern and better adapted to the needs of international trade than national laws; in addition, the adoption of harmonized laws facilitates trade with a greater number of countries than the adoption of a national law; furthermore, by adopting an international text, the State makes its law more readily understandable to foreign trading partners, and thus reduces the need for choice-of-law clauses in commercial contracts and decreases the number of instances in which domestic traders would have to operate under a foreign and unknown national law. Consequently, the Commission may wish to call upon the States concerned to bear in mind the advantages of internationally harmonized legislation, as well as to call upon the international organizations providing technical assistance to assist the relevant legislative officials in making informed decisions about the use of harmonized legal texts.

50. As to laws dealing specifically with privatization (above, paras. 9-10), it appears that the needs of States, and the issues to be addressed in those laws, differ considerably, depending on factors such as the extent of privatization to be carried out, the social and other policies underlying the privatization, and the existence of laws supporting private ownership of enterprises. The Commission may wish to consider that the work of organizations mentioned above in paragraphs 36 to 48 in disseminating expertise for the preparation of such laws is useful and should be encouraged.

51. As to the legal issues in privatization contracts (above, paras. 11-35), the Commission may wish to consider that the Secretariat should continue to monitor the development of the contract practices and the manner in which the organizations active in the area are addressing problems that arise in practice. The Secretariat would report to the Commission at a future session, and present suggestions, in the event that there would appear to be a need for the Commission itself to undertake work on those issues.